



[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9652]

RIN 1545-BI57

Sales-Based Royalties and Vendor Allowances

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the capitalization and allocation of royalties that are incurred only upon the sale of property produced or property acquired for resale (sales-based royalties). This document also contains final regulations relating to adjusting inventory costs for a type of an allowance, discount, or price rebate earned on the sale of merchandise (sales-based vendor chargebacks). These regulations modify the simplified production method and the simplified resale method of allocating capitalized costs between ending inventory and cost of goods sold. These regulations affect taxpayers that incur capitalizable sales-based royalties or earn sales-based vendor chargebacks.

DATES: Effective date: These regulations are effective on **[INSERT THE DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Comment date: Comments will be accepted until **[INSERT DATE 90 DAYS AFTER PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Applicability date: For dates of applicability, see §§1.263A-1(l), 1.263A-2(f),

1.263A-3(f), and 1.471-3(g).

ADDRESSES: Written (including electronic) comments should be submitted to Internal Revenue Service, CC:PA:LPD:PR (REG-149338-08), Room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044, or electronically to www.regulations.gov (IRS REG-149338-08). Alternatively, comments may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-149338-08), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. All comments will be available for public inspection and copying.

FOR FURTHER INFORMATION CONTACT: John Roman Faron, (202) 317-6950 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains final regulations that amend the Income Tax Regulations (26 CFR part 1) relating to the allocation under section 263A of the Internal Revenue Code (Code) of certain sales-based royalties and relating to the determination of cost of merchandise in inventory under section 471 when a taxpayer earns a type of sales-based vendor allowance. On December 17, 2010, a notice of proposed rulemaking (REG-149335-08) was published in the Federal Register (75 FR 78940). Written comments responding to the notice of proposed rulemaking were received. The comments are available for public inspection at www.regulations.gov or on request. A public hearing was requested and held on April 13, 2011. After consideration of all the comments, the proposed regulations are adopted as revised by this Treasury decision.

The comments are discussed in the preamble.

Summary of Comments and Explanation of Provisions

Sales-based royalties

The proposed regulations clarified that sales-based royalties, like other royalties, may be capitalizable to property a taxpayer produces or acquires for resale. Royalty costs are capitalizable when they are incurred in securing the contractual right to use a trademark, corporate plan, manufacturing procedure, special recipe, or other similar right associated with property produced or property acquired for resale. Sales-based royalty costs are royalties that are incurred only upon the sale of property produced or acquired for resale.

The proposed regulations provided that sales-based royalties required to be capitalized must be allocated only to property that has been sold or, for inventory property, deemed to be sold under the taxpayer's inventory cost flow assumption. In response to concerns that the requirement to allocate sales-based royalties only to cost of goods sold would unduly burden taxpayers using simplified allocation methods, the final regulations provide that the allocation of sales-based royalties to property sold is optional rather than mandatory. Therefore, the final regulations permit taxpayers to either allocate sales-based royalties entirely to property sold and include those costs in cost of goods sold or to allocate sales-based royalties between cost of goods sold and ending inventory using a facts-and-circumstances cost allocation method described in §1.263A-1(f) or a simplified method provided in §1.263A-2(b) (the simplified production method) or §1.263A-3(d) (the simplified resale method). The final regulations also clarify that sales-based royalties that a taxpayer allocates entirely to inventory property sold are included in cost of goods sold and

may not be included in determining the cost of goods on hand at the end of the taxable year regardless of the taxpayer's cost flow assumption.

A commentator suggested that the final regulations acknowledge that a sales-based royalty payable by a reseller of inventory to its supplier is a direct acquisition cost under section 471 and included in cost of goods sold when the inventory item is sold. The final regulations do not adopt this comment because whether a cost is a royalty described in §1.263A-1(e)(3)(ii)(U) or is a contingent acquisition cost is beyond the scope of these regulations.

Sales-based vendor allowances in general

The proposed regulations provided that the amount of an allowance, discount, or price rebate that a taxpayer earns by selling specific merchandise is a reduction in the cost of the merchandise sold or deemed sold under a taxpayer's cost flow assumption. The preamble to the proposed regulations referred to this type of allowance as a sales-based vendor allowance. The proposed regulations required that these allowances reduce cost of goods sold and not reduce ending inventory cost or value of goods on hand at the end of the taxable year.

A commentator disagreed with the requirement in the proposed regulations that the vendor allowances described in the proposed regulations always must reduce cost of goods sold. The commentator disputed that a vendor allowance should reduce cost of goods sold merely because the allowance is dependent on a sale of merchandise.

Citing Pittsburgh Milk Co. v. Commissioner, 26 T.C. 707 (1956), the commentator suggested that sales-based vendor allowances that are the subject of an advance agreement between the vendor and the purchaser at the time the merchandise is

purchased must be netted against the original cost of the merchandise and applied to ending inventory or cost of goods sold depending on the taxpayer's inventory cost flow assumption. Accordingly, the commentator suggested that the regulations be revised to provide that a sales-based vendor allowance may properly reduce the value of goods on hand at the end of the taxable year.

The final regulations reflect the commentator's suggestion that a vendor allowance does not reduce the cost of goods sold merely because the allowance is dependent on a sale of merchandise. The proposed regulations were overbroad because they required taxpayers to allocate to cost of goods sold all allowances that arise from selling merchandise. For example, if, after selling a certain number of units, a taxpayer earns a discount off each unit purchased during the taxable year, the allowance properly may be allocable to both the cost of units that remains in ending inventory and the cost of units included in cost of goods sold during the year. Similarly, a sales-volume allowance that provides only a reduction in the cost of any purchases made by a taxpayer in the next taxable year properly reduces the cost of the units of the product purchased in the next year. As the preceding two examples illustrate, the proposed regulations were overbroad in that they could be interpreted to require these allowances to reduce cost of goods sold solely because they arose as a result of selling merchandise. The extent to which a vendor allowance is properly allocable to the cost of goods in ending inventory or the cost of goods sold depends on all facts and circumstances, including the terms and conditions of the agreement between the vendor and the taxpayer. See Pittsburgh Milk Co. v. Commissioner. As described later in this preamble, the final regulations more clearly identify a type of sales-based vendor

allowance that, to clearly reflect income, must reduce the cost of goods sold.

The commentator also asserted that Rev. Rul. 2001-8 (2001-1 CB 726), see §601.601(d)(2), and earlier rulings support the proposition that sales-based vendor allowances are an adjustment to the cost of merchandise physically removed from inventory. Although allowances, discounts, and price rebates properly are treated as adjustments to the price of merchandise, the final regulations do not adopt the commentator's rationale for determining whether these adjustments properly reduce ending inventory or cost of goods sold. Rev. Rul. 2001-8 does not establish a general principle that sales-based vendor allowances reduce the invoice cost of merchandise physically sold. Rev. Rul. 2001-8 addresses a unique cost adjustment (floor stocks payments) that relates to goods physically on hand on a particular date and should not be applied beyond its specific facts.

Sales-based vendor chargebacks

In response to comments that the proposed regulations were overbroad, the Treasury and IRS are considering alternatives to a broad definition of sales-based vendor allowances. The final regulations, however, specifically identify one type of sales-based vendor allowance (sales-based vendor chargebacks) that, to clearly reflect income, reduces cost of goods sold and does not reduce the cost of goods on hand at the end of the taxable year. Therefore, the final regulations apply the rule articulated in the notice of proposed rulemaking to sales-based vendor chargebacks. A sales-based vendor chargeback is defined as an allowance, discount, or price rebate that a taxpayer becomes unconditionally entitled to by selling a vendor's merchandise to specific customers identified by the vendor at a price determined by the vendor. Sales-based

vendor chargebacks protect a taxpayer from realizing a loss or a reduced profit on the sale of specific merchandise when the taxpayer is obligated by contract with the vendor of the merchandise to resell the merchandise at a specific price (in some cases below the taxpayer's cost). Under the terms and conditions of the agreement between the vendor and the taxpayer and the economics of the transaction, it is inappropriate to treat the allowance as an adjustment to the cost of goods in ending inventory. A sales-based vendor chargeback properly reduces only cost of goods sold because it arises from and relates only to merchandise sold. Thus, it reduces the invoice cost of the merchandise sold and clearly reflects income only if it reduces cost of goods sold.

Sales-based vendor allowances other than chargebacks

The final regulations reserve rules for the treatment of other sales-based vendor allowances. Given the factual nature of particular vendor allowance arrangements between sellers and purchasers of merchandise, the IRS and Treasury Department request comments regarding additional guidance defining or describing particular sales-based vendor allowances and on objective rules for allocating such allowances to the purchase price of goods acquired in the future, ending inventory, or cost of goods sold.

Effective/Applicability Date

These regulations apply for taxable years ending on or after **[INSERT DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Special Analyses

This Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. Section 553(b) of the Administrative Procedure

Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking that preceded these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. No comments were received from the Small Business Administration.

Drafting Information

The principal author of these regulations is John Roman Faron of the Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.263A-1 also issued under 26 U.S.C. 263A.

Section 1.263A-2 also issued under 26 U.S.C. 263A.

Section 1.263A-3 also issued under 26 U.S.C. 263A. * * *

Section 1.471-3 also issued under 26 U.S.C. 471. * * *

Par. 2. Section 1.263A-0 Table of Contents is amended by adding new entries for §§1.263A-1(c)(5), (k), and (l); 1.263A-2(b)(3)(ii)(C), (e), and (f); 1.263A-3(d)(3)(i)(C)(3) and (f); and revising the entry for §1.263A-1(e)(3)(ii) to read as follows:

§1.263A-0 Outline of regulations under section 263A.

* * * * *

§1.263A-1 Uniform Capitalization of Costs.

* * * * *

(c) * * *

(5) Costs allocable only to property sold.

* * * * *

(e) * * *

(3) * * *

(ii) Examples of indirect costs required to be capitalized.

* * * * *

(k) Change in method of accounting.

(1) In general.

(2) Scope limitations.

(3) Audit protection.

(4) Section 481(a) adjustment.

(5) Time for requesting change.

(l) Effective/applicability date.

§1.263A-2 Rules Relating to Property Produced by the Taxpayer.

* * * * *

(b) * * *

(3) * * *

(ii) * * *

(C) Costs allocable only to property sold.

* * * * *

(e) Change in method of accounting.

(1) In general.

(2) Scope limitations.

(3) Audit protection.

(4) Section 481(a) adjustment.

(5) Time for requesting change.

(f) Effective/applicability date.

§1.263A-3 Rules Relating to Property Acquired for Resale.

* * * * *

(d) * * *

(3) * * *

(i) * * *

(C) * * *

(3) Costs allocable only to property sold.

* * * * *

(f) Effective/applicability date.

* * * * *

Par. 3. Section 1.263A-1 is amended by:

1. Adding a paragraph (c)(5).
2. Revising paragraph (e)(3)(i) and paragraph (e)(3)(ii) introductory text.
3. Redesignating paragraph (e)(3)(ii)(U) as paragraph (e)(3)(ii)(U)(1), revising the second sentence of newly-designated paragraph (e)(3)(ii)(U)(1), and adding a sentence to the end of newly-designated paragraph (e)(3)(ii)(U)(1).
4. Adding paragraph (e)(3)(ii)(U)(2).
5. Revising paragraph (l).

The additions and revisions read as follows:

§1.263A-1 Uniform capitalization of costs.

* * * * *

(c) * * *

(5) Costs allocable to property sold. A cost that is allocated under this section, §1.263A-2, or §1.263A-3 entirely to property sold must be included in cost of goods sold and may not be included in determining the cost of goods on hand at the end of the taxable year.

* * * * *

(e) * * *

(3) * * *

(i) In general. (A) Indirect costs are defined as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in

the case of property acquired for resale). Taxpayers subject to section 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale. Indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities. Indirect costs may directly benefit or be incurred by reason of the performance of production or resale activities even if the costs are calculated as a percentage of revenue or gross profit from the sale of inventory, are determined by reference to the number of units of property sold, or are incurred only upon the sale of inventory. Indirect costs may be allocable to both production and resale activities, as well as to other activities that are not subject to section 263A. Taxpayers must make a reasonable allocation of indirect costs between production, resale, and other activities.

(B) Example. The following example illustrates the provisions of this paragraph (e)(3)(i):

Example. (i) Taxpayer A manufactures tablecloths and other linens. A enters into a licensing agreement with Company L under which A may label its tablecloths with L's trademark if the tablecloths meet certain specified quality standards. In exchange for its right to use L's trademark, the licensing agreement requires A to pay L a royalty of \$X for each tablecloth carrying L's trademark that A sells. The licensing agreement does not require A to pay L any minimum or lump-sum royalties.

(ii) The licensing agreement provides A with the right to use L's intellectual property, a trademark. The licensing agreement also requires A to conduct its production activities according to certain standards as a condition of exercising that right. Thus, A's right to use L's trademark under the licensing agreement is directly related to A's production of tablecloths. The royalties the licensing agreement requires A to pay for using L's trademark are the costs A incurs in exchange for these rights. Therefore, although A incurs royalty costs only when A sells a tablecloth carrying L's trademark, the royalty costs directly benefit production activities and are incurred by reason of production activities within the meaning of paragraph (e)(3)(i)(A) of this section.

(ii) Examples of indirect costs required to be capitalized. The following are examples of indirect costs that must be capitalized to the extent they are properly allocable to property produced or property acquired for resale:

* * * * *

(U) Licensing and franchise costs. (1) * * * These costs include the otherwise deductible portion (such as amortization) of the initial fees incurred to obtain the license or franchise and any minimum annual payments and any royalties that are incurred by a licensee or a franchisee. These costs also include fees, payments, and royalties otherwise described in this paragraph (e)(3)(ii)(U) that a taxpayer incurs (within the meaning of section 461) only upon the sale of property produced or acquired for resale.

(2) If a taxpayer incurs (within the meaning of section 461) a fee, payment, or royalty described in this paragraph (e)(3)(ii)(U) only upon the sale of property produced or acquired for resale and the cost is required to be capitalized under this paragraph (e)(3), the taxpayer may properly allocate the cost entirely to property produced or acquired for resale by the taxpayer that has been sold.

* * * * *

(I) Effective/applicability date. (1) Paragraphs (h)(2)(i)(D), (k), and (l) of this section apply for taxable years ending on or after August 2, 2005.

(2) Paragraphs (c)(5), (e)(3)(i), and (e)(3)(ii)(U) of this section apply for taxable years ending on or after **[INSERT THE DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Par. 4. Section 1.263A-2 is amended by adding paragraphs (b)(3)(ii)(C) and (b)(4)(ii)(A)(4) and revising paragraph (f) to read as follows:

§1.263A-2 Rules relating to property produced by the taxpayer.

* * * * *

(b) * * *

(3) * * *

(ii) * * *

(C) Costs allocated to property sold. Additional section 263A costs incurred during the taxable year, as defined in paragraph (b)(3)(ii)(A)(1) of this section, section 471 costs incurred during the taxable year, as defined in paragraph (b)(3)(ii)(A)(2) of this section, and section 471 costs remaining on hand at year end, as defined in paragraph (b)(3)(ii)(B) of this section, do not include costs described in §1.263A-1(e)(3)(ii) or cost reductions described in §1.471-3(e) that a taxpayer properly allocates entirely to property that has been sold.

* * * * *

(4) * * *

(ii) * * *

(A) * * *

(4) Additional section 263A costs incurred during the test period, as defined in paragraph (b)(4)(ii)(A)(2) of this section, and section 471 costs incurred during the test period, as defined in paragraph (b)(4)(ii)(A)(3) of this section, do not include costs specifically described in §1.263A-1(e)(3)(ii) or cost reductions described in §1.471-3(e) that a taxpayer properly allocates entirely to property that has been sold.

* * * * *

(f) Effective/applicability date. (1) Paragraphs (b)(2)(i)(D), (e), and (f) of this

section apply for taxable years ending on or after August 2, 2005.

(2) Paragraphs (b)(3)(ii)(C) and (b)(4)(ii)(A)(4) of this section apply for taxable years ending on or after **[INSERT THE DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Par. 5. In §1.263A-3, paragraphs (d)(3)(i)(C)(3), (d)(3)(i)(D)(3), (d)(3)(i)(E)(3), and (f) are added to read as follows:

§1.263A-3 Rules relating to property acquired for resale.

* * * * *

(d) * * *

(3) * * *

(i) * * *

(C) * * *

(3) Costs allocable to property sold. Section 471 costs remaining on hand at year end, as defined in paragraph (d)(3)(i)(C)(2) of this section, do not include costs that are specifically described in §1.263A-1(e)(3)(ii) or cost reductions described in §1.471-3(e) that a taxpayer properly allocates entirely to property that has been sold.

(D) * * *

(3) Current year's storage and handling costs, beginning inventory, and current year's purchases, as defined in paragraph (d)(3)(i)(D)(2) of this section, do not include costs that are specifically described in §1.263A-1(e)(3)(ii) or cost reductions described in §1.471-3(e) that a taxpayer properly allocates entirely to property that has been sold.

(E) * * *

(3) Current year's purchasing costs and current year's purchases, as defined in

paragraph (d)(3)(i)(E)(2) of this section, do not include costs that are specifically described in §1.263A-1(e)(3)(ii) or cost reductions described in §1.471-3(e) that a taxpayer properly allocates entirely to property that has been sold.

* * * * *

(f) Effective/applicability date. Paragraphs (d)(3)(i)(C)(3), (d)(3)(i)(D)(3), and (d)(3)(i)(E)(3) of this section apply for taxable years ending on or after **[INSERT THE DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

Par. 6. Section 1.471-3 is amended by:

1. Adding paragraphs (e) and (g).
2. Designating the undesignated text following paragraph (d) as paragraph (f).

The additions read as follows:

§1.471-3 Inventories at cost.

* * * * *

(e) Sales-based vendor allowances--(1) Treatment of sales-based vendor chargebacks--(i) In general. A sales-based vendor chargeback is an allowance, discount, or price rebate that a taxpayer becomes unconditionally entitled to by selling a vendor's merchandise to specific customers identified by the vendor at a price determined by the vendor. A sales-based vendor chargeback decreases cost of goods sold and does not reduce the cost of goods on hand at the end of the taxable year.

(ii) Example. The following example illustrates the provisions of this paragraph (e)(1).

Example. (i) W is a wholesaler of pharmaceuticals. W purchases Drug X from the manufacturer, M, for \$10x per unit. M has agreements with specific customers that allow those customers to acquire Drug X from M's wholesalers for \$6x per unit. Under

an agreement between W and M, W is required to sell Drug X to specific customers at the prices M has negotiated with such customers (\$6x per unit) and, in exchange, M agrees to provide a price rebate to W equal to the difference between W's cost for Drug X and the price W is required to charge specific customers under the agreement (a difference of \$4x per unit). W sells Drug X to specific customer Y for \$6x. Under the agreement between W and M, the price rebate can be paid to W, credited against M's invoice to W for W's purchase of Drug X, or it can be credited to W's future purchases of drugs from M.

(ii) Under the terms of the agreement, W is unconditionally entitled to the price rebate of Drug X when it sells Drug X to specific customer Y, a specifically identified customer of M. The price rebate received by W for the sale of Drug X to Y is a sales-based vendor chargeback. Therefore, the amount of the sales-based vendor charge back, \$4x per unit for Drug X, whether paid to W, credited against M's invoice to W for W's purchase of Drug X or credited against a future purchase, decreases cost of goods sold and does not reduce the cost of Drug X on hand at the end of the taxable year.

(2) Treatment of other sales-based vendor allowances. [Reserved]

* * * * *

(g) Effective/applicability date. Paragraph (f) of this section applies to taxable years ending on or after **[INSERT THE DATE OF PUBLICATION OF THIS DOCUMENT IN THE FEDERAL REGISTER]**.

John Dalrymple
Deputy Commissioner for Services and Enforcement.

Approved: December 13, 2013

Mark J. Mazur
Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2014-00327 Filed 01/10/2014 at 8:45 am; Publication Date: 01/13/2014]